August 14 1998 **ANALYSIS**

Janet Bush sees little help for Moscow in the IMF's spend and squeeze formula

Devaluation looms large as lesser of two Russian evils

Russia's bear market frightens the West

Russian freefall batters world markets

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Seasoned observers of the tables of the Casino of the Global Economy always knew behind their poker faces that the euphoria that greeted last month's $22.6 billion International Monetary Fund support package for Russia would not last long.

Less than a month later, the Russian stock market is in crisis, talk has resurfaced, to be fiercely denied by the authorities in Moscow, that a devaluation of the rouble is inevitable and George Soros, currency speculator and Eastern Europe's most cherished financial philanthropist, is urging the creation of a Group of Seven-backed $50 billion dollar currency board to stabilise and protect the Russian exchange rate.

Mr Soros, writing yesterday to *The Financial Times*, said that the "melt-down in Russian financial markets has reached the terminal phase". He laid the blame at the door of the IMF. "The IMF programme imposes tight monetary and fiscal policy; the banking crisis requires the injection of liquidity. The two requirements cannot be reconciled with further international assistance."

Mr Soros suggested that, rather than the current, gradually depreciating peg of the rouble against the dollar, the best solution to the current crisis would be to introduce a currency board after a "modest devaluation of 15 to 25 per cent".

This suggestion was immediately rejected by Denis Kiselyov, Deputy Chairman of Russia's central bank. "A one-off devaluation of 15 to 25 per cent would not solve a single one of the problems facing the Russian Government," he said.

Russian officials were bound to respond to Mr Soros's suggestion thus. Relative rouble stability has helped Russia to achieve a dramatic reduction in inflation to just over 4 per cent, compared with inflation or more than 1,000 per cent after the collapse of communism in 1991. In what has been a tortuous transition to market economics, which has still left the Government unable to pay millions of Russian workers their wages, this has been a singular achievement that the authorities do not want to compromise.

However, Mr Soros's ideas cannot easily be dismissed. Russia faces some tough choices if it is emerge from the crisis of confidence that, more than contagion effects from Asia, is due to the collapse in the price of crude oil which, with gas, accounts for more than 50 per cent of its exports.

The current emphasis of IMF policy-makers, the US Treasury and other members of the G7 is on efforts to bolster tax collection to plug Russia's deteriorating financial position and enable the authorities to pay out wages. However, this is a long-term effort and, with the Duma, Russia's Communist-dominated Parliament, already proving intransigent, even early progress in this respect is being stunted. Structural reforms, always urged by the IMF, are all very well but they are not the answer to short-term crisis.

Broadly, Russia faces two very difficult choices if it is to plug the current account black hole left by the slump in world oil prices and to restore its public finances to health. It could impose a severe fiscal squeeze on an already mutinous population or it could devalue the rouble.

Some observers believe that, despite the absolutist tone of current rhetoric on maintaining the rouble peg with the dollar, opinion is shifting towards the latter.

The one serious bar to devaluation is the huge forward currency exposure of Russian banks to the rouble. If the rouble were to be devalued now, these banks would be destroyed, creating an even more terminal crisis in confidence. However, a large proportion of these forward contracts will expire by October and November. Unless the IMF and America, its largest shareholder, were to successfully veto such a move, a devaluation towards the end of the year might be deemed political preferable to another austerity package.

Although even talking about the relative desirability of a devaluation is taboo in current, highly unstable conditions, some economists argue that a bold devaluation would go down far better with Russians than another swingeing fiscal squeeze - perhaps on consumption - in an economy whose gross domestic product has already contracted by half over less than a decade.

Whatever Russia eventually decides to do, without a miraculous recovery in oil prices or something else to persuade foreigners to go on financing its budget deficit, it will need considerable additional funds from the IMF and the G7.

Kasper Bartholdy, fixed income strategist at Credit Suisse First Boston, believes an additional $15 billion is probably a minimum and that the $50 billion quoted by Mr Soros as the necessary backing for a currency board is certainly not outrageous.

There seems little doubt that the IMF and the G7 are willing to do what it takes to bail Russia out of its current difficulties. If South Korea was too strategically important to be allowed to fail, then how much more crucial is the relative political stability and the transition to a market economy in Russia which is, let it not be forgotten, a nuclear power.

The trouble is the logical inconsistency between injecting billions of dollars of liquidity into Russia and then squeezing it again through high interest rates, the identikit prescription that the IMF always resorts to in such situations.

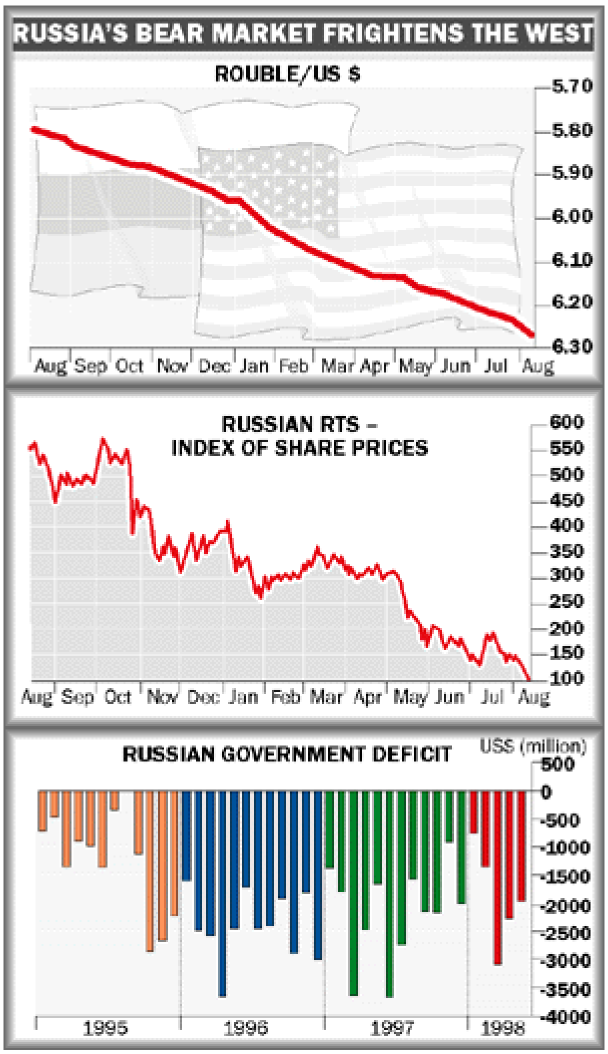
Interest rates in Russia have soared to 150 per cent, instant death to a country whose banking sector is in crisis. Mr Bartholdy of CSFB draws a comparison with Bulgaria which, faced with a far worse economic crisis than Russia, including hyperinflation, adopted a currency board last year. It now has interest rates of around 10 per cent and a stable currency.

A currency board may be workable, even in Russia. It would have to be set up, as Mr Soros suggests, *after* a large devaluation, and it would have to be backed by a great deal of money to give it credibility. Interest rates would probably have to be kept very high at first but they are painfully high already. Another enormous challenge is setting up a currency board in crisis conditions. It would look suspiciously like an easy target to speculators (presumably not including Mr Soros's Quantum Fund).

The alternative is more radical still. Let the rouble float freely but implement some disincentives against foreign banks that might have fun speculating. Tell them that, if the rouble were to fall 20 per cent, Russia would declare a moratorium on all debts. A further 10 per cent down and Russia would revoke 20 per cent of debts. A further 10 per cent ... and so on.

Such an incentive-based approach would be more effective than the IMF's failed policy of squeezing the liquidity lifeblood out of economies in crisis and then having to spend billions sorting out its own mess to little effect.

Surprisingly, this might prove politically popular. The value of the rouble in their pockets may decline but at least Russians would welcome an end to its Government's passive acceptance of Western billions at an insupportable price.



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